Supreme Court, U.S.
FILED

No. 06-843

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In The

Supreme Court of the United States

LARRY MORRISON,

Petitioner,

v.

MADISON DEARBORN CAPITAL PARTNERS III L.P.,
MADISON DEARBORN SPECIAL EQUITY III L.P.,
MADISON DEARBORN PARTNERS III L.P.,
MADISON DEARBORN PARTNERS LLC,
XM SATELLITE RADIO HOLDINGS INC.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Circuit Court's failure to follow the plain language of an agency regulation, which was consistent with both the contemporary regulatory history and subsequent releases disseminated by the agency, is inconsistent with this Court's precedents concerning the proper method for interpreting agency regulations?

2. Whether the Circuit Court's conclusion that it was inconsistent with the statutory purpose of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b) (2006) ("Section 16(b)") to impose liability on a statutory insider where the subject transaction was involuntary is consistent with this Court's precedent analyzing the statutory purpose of Section 16(b) and concluding that both involuntariness and a lack of access to inside information are necessary for a transaction to be outside the scope of Section 16(b)?

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OPINION BELOW

The opinion of the court of appeals, (App. 1-8),[1] is reported at 463 F.3d 312. The opinion of the district court is reported at 389 F. Supp. 2d 596. (App. 9-22).

JURISDICTION

The court of appeals issued its decision on September 17, 2006 and the judgment was issued on September 19, 2006. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS AND REGULATORY PROVISIONS INVOLVED

This case arises under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b) (2006) ("Section 16(b)") which provides in relevant part:

> Profits from purchase and sale of security within six months. For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security

[1] Documents reproduced in the Appendix to this petition will hereinafter be referenced as ("App. ___").

> within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

This case primarily involves the interpretation of Rule 16b-6(a) promulgated by the Securities and Exchange Commission ("SEC" or the "Commission"), 17 C.F.R. §240.16b-6(a) (2006), pursuant to Section 16(b) providing that:

> The establishment of or increase in a call equivalent position or liquidation of or decrease in a put equivalent position shall be deemed a purchase of the underlying security for purposes of section 16(b) of the Act, and the establishment of or increase in a put equivalent position or liquidation of or decrease in a call equivalent position shall be deemed a sale of the underlying securities for purposes of section 16(b) of the Act: *Provided, however*, that if the increase or decrease occurs

> as a result of the fixing of the exercise price of a right initially issued without a fixed price, where the date the price is fixed is not known in advance and is outside the control of the recipient, the increase or decrease shall be exempt from section 16(b) of the Act with respect to any offsetting transaction within the six months prior to the date the price is fixed.

I. STATEMENT OF THE CASE

A. The Nature of The Case

This action arises under Section 16(b) and is brought on behalf of XM Satellite Radio Holdings, Inc. ("XM" or the "Company") by Larry Morrison, a shareholder of XM. Plaintiff-petitioner alleges that Defendants Madison Dearborn Capital Partners III, L.P., Madison Dearborn Special Equity III, L.P., Madison Dearborn Partners III, L.P. and Madison Dearborn Partners, LLC (collectively referred to herein as "Defendants" or "Madison") were at all relevant times statutory insiders of XM subject to the liability provisions of Section 16(b) and realized short-swing insider trading profits recoverable under Section 16(b) from the purchase and corresponding sale of XM common stock (the "Common Stock").

B. Statement Of Facts

XM is a publicly traded company, the common stock of which (the "Common Stock") is registered with the SEC pursuant to Section 12 of the Securities Exchange Act of 1934. Defendants were part of a group whose members collectively owned more than ten percent of the outstanding common stock of XM and also designated a member to sit on XM's board of directors.

On or about August 8, 2000, Madison acquired 50,000 shares of Series C Preferred Stock (the "Preferred Stock") for $1,000 per share or a total of $50,000,000. At the time it was issued, the Preferred Stock was convertible into 1,886,792 shares of Common Stock at a price of $26.50 per share (the "Conversion Price").

The Conversion Price, however, was subject to downward adjustment if the Company sold securities to other investors below the Conversion Price. This downward adjustment in the Conversion Price, in turn, increased the number of shares of Common Stock into which the Preferred Stock was convertible.

Prior to January 28, 2003, the Conversion Price was $19.68. XM then issued additional securities to new investors,[2] causing the Conversion Price to be adjusted downward to $8.96 by June 30, 2003. This decrease in the Conversion Price caused Madison to acquire the right to purchase an additional 3,039,707 shares of Common Stock.[3]

Also, in June 2003, within six months of the changes in the Conversion Price, Defendants sold 2,674,154 shares

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[2] The additional issuances included the sale of $210.0 million of 10% Senior Secured Discount Convertible Notes due December 31, 2009 to certain institutional and accredited investors. *See* January 29, 2003, Form 8-K at 4, *available at* http://www.sec.gov/cgi-bin/browse-edgar (File No. 000-27441). Petitioner will be pleased to lodge a copy of the Form 8-K or any other document referenced in this petition at the request of the Court.

[3] At a conversion price of $8.96 the Preferred Stock was convertible into 5,580,357 shares of Common Stock ($50,000,000 ÷ $8.96 = 5,580,357), while at the previously existing conversion price of $19.68, the Preferred Stock was convertible into 2,540,650 shares of Common Stock ($50,000,000 ÷ $19.68 = 2,540,650).

of XM Common Stock at prices exceeding the purchase price. *See* July 14, 2003 Schedule 13D at Item 4, *available at* http://www.sec.gov/cgi-bin/browse-edgar (File No. 000-27441). As a result, Defendants earned millions of dollars in short-swing insider trading profits.

C. Proceedings in the District Court

On January 7, 2004, Plaintiff filed his Complaint in the United States District Court for the District of Delaware. On March 1, 2004, Defendants moved, pursuant to Fed. R. Civ. P. 12(b)(6), to dismiss the Complaint for failure to state a claim for relief. Plaintiff opposed the motion. The District Court, on October 5, 2005, and without having taken oral argument on the motion, issued a Memorandum Opinion and an Order granting Defendants' motion to dismiss.

D. Proceedings in the Court of Appeals

Petitioner filed a Notice of Appeal on November 2, 2005 and timely filed his opening brief on January 26, 2006. Oral argument was originally scheduled for September 14, 2006, but was subsequently cancelled, with the Circuit Court choosing to take the case on submission pursuant to Local Appellate Rule 34.1(b). On September 19, 2006, the Circuit Court issued its decision and on October 11, 2006, the Circuit Court issued its mandate.

II. REASONS FOR GRANTING THE PETITION

The Circuit Court decision conflicts with decisions of this Court and other Circuit Courts holding that where the

language of a regulation is clear, there is no need to consult the regulatory history. Also, the Circuit Court's reliance on a snippet of regulatory history taken out of context while ignoring other indicia of the regulation's meaning, including other relevant portions of the regulatory history and no-action letters written by staff attorneys at the SEC, is contrary to this Court's guidance on the correct means of interpreting statutes. Finally, the Circuit Court's interpretation of the statutory purpose of Section 16(b) is contrary to the views previously expressed by this Court on the very same subject.

A. The Circuit Court's Interpretation of Rule 16b-6(a) is Inconsistent With Principles of Statutory Interpretation Employed by This Court

This Court requires that agency regulations be interpreted in a manner similar to statutes with the first inquiry being on the plain language of the rule. *See, e.g., Christensen v. Harris County*, 529 U.S. 576 (2000). These devices of judicial construction are "the regulation's plain language" and "other indications of . . . intent ***at the time of the regulation's promulgation.***" *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994) (emphasis added). Here, Petitioner respectfully submits, these devices of judicial construction demonstrate that the Circuit Court erred in its interpretation of Rule 16b-6(a) and, in doing so, acted contrary to decisions of this Court as to how Courts should interpret agency regulations.

1. The Circuit Court's Interpretation of Rule 16b-6(a) is Inconsistent With the Plain Language of the Rule

The law of statutory interpretation is clear that where the plain language of a statute (or regulation) is clear, there is no need, nor is it even permitted to review the statutory (or regulatory) history in order to determine the correct meaning. *See, e.g., Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 119 (2001) (citing *Ratzlaf v. U.S.*, 510 U.S. 135, 147-48 (1994) ("we do not resort to legislative history to cloud a statutory text that is clear."). *Accord, Roberto v. Dep't of the Navy*, 440 F.3d 1341, 1350 (Fed. Cir. 2006) (where "the plain meaning of the regulation is clear, no further inquiry is required into agency interpretations or the regulatory history to determine its meaning.") (citing *Meeks v. West*, 216 F.3d 1363, 1366 (Fed. Cir. 2000)); *International Brotherhood of Elec. Workers, Local Union No. 474, AFL-CIO v. NLRB*, 814 F.2d 697, 712 (1987) ("courts have no authority to enforce [a] principle gleaned solely from legislative history that has no statutory reference point.").

Rule 16b-6(a) provides that: "The establishment of or ***increase*** in a call equivalent position . . . shall be deemed a purchase of the underlying security for purposes of section 16(b) of the Act." 17 C.F.R. §240.16b-6(a) (2006) (emphasis added). The more than 3 million additional shares of Common Stock into which the Preferred Stock became convertible as a result of the change in the Conversion

Price is precisely such an increase in a call equivalent position.[4]

The text of Rule 16b-6(a) provides for only one limited exemption from Section 16(b) liability where, as here, purchases occur through increases in a call equivalent position. However, that exemption applies only where, "[1] the date the price is fixed is not known in advance and [2] is outside the control of the recipient," and is further limited to "[3] ***any offsetting transaction within the six months prior to the date the price is fixed.***" *See* 17 C.F.R. § 240.16b-6(a) (emphasis added).

Even assuming *arguendo* that the first two elements of this test have been satisfied here – a matter which Petitioner disputes – this exemption still can not apply. The sale triggering the Section 16(b) profit occurred ***after*** the acquisition triggered by Rule 16b-6(a) and the increase in the call equivalent position caused by the decrease in the Conversion Price. Thus, the purchase caused by reducing the Conversion Price is outside the limited exemption afforded by Rule 16b-6(a). *Accord*, *Ownership Reports and Trading By Officers, Directors and Principal Security Holders*, Exchange Act Release 28869, 56 Fed. Reg. 7242, 7253 (Feb. 21, 1991) ("1991 SEC Release") ("The rules have been modified to provide that if the timing of the event fixing the price is outside the control

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[4] It is undisputed that this contractual term allowing for the conversion of Common Stock at a fixed price caused the Preferred Stock owned by Defendants constituted to be a "call equivalent position" within the meaning of Rule 16a-1(b) because it was security that "increases in value as the value of the underlying equity increases. . . ." 17 C.F.R. § 240.16a-1(b) (2006); *see also*, *Morrison*, 469 F.3d at 315 (App. 5).

and knowledge of the holder, then the acquisition would be . . . exempt from section 16(b) matching with sales occurring before the fixing of the exercise price, ***but will not be exempt from section 16(b) matching with sales occurring thereafter***.") (emphasis added).

Therefore, the plain language of Rule 16b-6(a) demonstrates that the transaction at issue in this case was a purchase within the meaning of the rule and that no exemption is available under the terms of the rule. Given the clarity of the rule's language, under this Court's controlling precedents, this should have ended the Circuit Court's inquiry into the correct meaning of Rule 16b-6(a). *Accord*, *Circuit City Stores, supra*.

2. The Circuit Court's Interpretation of Rule 16b-6(a) is Inconsistent With the Regulatory History of the Rule

Instead of ending its inquiry with the rule's plain meaning, the Circuit Court referred to a single line in a footnote of the 1991 SEC Release stating that: "The adjustment for pre-specified events do not constitute acquisitions of additional equity securities." *Morrison*, 469 F.3d at 315; (App. 6-7) (citing 1991 SEC Release, 56 Fed. Reg. 7242, 7252 n.134). However, this line was read by the Circuit Court completely out of context and, therefore, can not support the interpretation advanced by the Circuit Court for Rule 16b-6(a). *Accord*, *Rust v. Sullivan*, 500 U.S. 173, 189 (1991).

Petitioner respectfully submits that the first error of context made by the Circuit Court relates to the location of this footnote within the 1991 SEC Release. The text of the discussion to which the footnote relates only deals with

which securities fall within the definition of a "derivative security." *See* 1991 SEC Release, 56 Fed. Reg. at 7252.[5] Also, the section of the 1991 SEC Release in which this entire discussion is found is titled "Definitions of Equity Securities of an Issuer and Derivative Security." *See* 1991 SEC Release, 56 Fed. Reg. at 7251.

Therefore, the portion of the 1991 SEC Release upon which the Circuit Court relied only addresses the circumstances in which a security is a derivative security – an issue not in dispute in this action.[6] However, the footnote relied upon by the Circuit Court does not speak to whether the acquisition of a derivative security constitutes a purchase within the meaning of Rule 16b-6(a).

Instead, the relevant portion of the regulatory history is in the next section, titled "Acquisition of Derivative Securities." 1991 SEC Release, 56 Fed. Reg. at 7252. There, the regulatory history states that:

> When an insider purchases a derivative security in the open market or in a negotiated transaction, ***or is granted a derivative security by the issuer***, the opportunity to realize short-swing profit begins.

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[5] Specifically, the text accompanying footnote 134 of the 1991 SEC Release upon which the Circuit Court relied states:

> Derivative securities are defined in the rules to include options and convertible securities, and similar rights whose value depends upon the value of the issuer's equity securities. The definition has been clarified to exclude securities without a fixed exercise price.[134]

1991 SEC Release, 56 Fed. Reg. at 7252.

[6] *See* n.3, *supra*.

1991 SEC Release, 56 Fed. Reg. at 7252 (emphasis added). Here, the additional shares of Common Stock acquired by Defendants as a result of the decrease in the Conversion Price represents a grant of a derivative security by the issuer (XM) to Defendants (based upon a contractual obligation which Madison had undoubtedly negotiated for and actively sought).

Also, Petitioner respectfully submits that the Circuit Court erred in failing to take account of the sentence immediately preceding the quoted footnote language relied upon. That sentence specifically refers to "pre-specified events ***such as a stock split.***" 1991 SEC Release, 56 Fed. Reg. at 7252 n.134 (emphasis added). However, here, the decrease in the Conversion Price which caused the purchase was not a stock split or even a transaction resembling a stock split.

In a stock split or stock dividend, all common stockholders are treated equally with the number of shares outstanding increased by a multiple common to all shares. *E.g.*, *Morales v. Lukens, Inc.*, 593 F. Supp. 1209, 1214 n.8 (S.D.N.Y. 1984); *see also*, Black's Law Dictionary at 1459 (Eighth Ed. 2004). It is common practice to adjust options by the same multiple applied to create the stock split or stock dividend to any option outstanding with respect to the shares that were the subject of such a stock dividend or stock split. *See*, *e.g.*, *Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change to Revise Option Adjustment Methodology*, Release No. 34-53400, 2006 SEC LEXIS 496 at *3 (March 2, 2006) (the "2006 SEC Release"). Thus, "[f]or example, in the event of a 2-for-1 split, an XYZ $60 option calling for the delivery of 100 shares of XYZ stock would be

subdivided into two XYZ $30 options, each calling for the delivery of 100 shares of XYZ stock." *Id.* at *3 n.3.

Here, in contrast, the transaction in which Madison acquired the right to purchase an additional 3,039,707 shares of Common Stock bears no resemblance to a stock split. The benefit which Madison received from the decrease in the Conversion Price did not flow to all of XM's shareholders but one which Madison alone enjoyed.

Therefore, a fair reading of the regulatory history of Rule 16b-6(a) also demonstrates that the transaction at issue in this action was subject to Section 16(b) liability through the operation of Rule 16b-6(a).

3. The Circuit Court's Interpretation of Rule 16b-6(a) is Inconsistent With SEC No-Action Letters Addressing the Rule

Also left unmentioned in the Circuit Court opinion are no-action letters issued by the SEC staff interpreting Rule 16b-6(a) and which conflict with the Circuit Court's decision. *Davis Polk & Wardwell*, SEC No-Act. LEXIS 1006 (Aug. 23, 1991), is on point as it involved stock options to purchase shares in an issuer at a specified price together with an adjustment to the underlying option. The adjustments, which were referred to as dividend equivalent rights ("DER"), accumulated and the participant received additional shares of common stock at the time of the option's exercise with respect to the DER. In response to a request for exemption, the SEC in *Davis Polk* opined that the initial option and the DER were two separate securities. The initial option was deemed to be a derivative security with the purchase price fixed at the time of grant.

The DER component, however, was only deemed acquired on the date its terms were fixed.

Similarly, *Jenny Craig, Inc.*, SEC No-Act. LEXIS 106 (Jan. 30, 1992), opined that where the number of shares underlying a warrant (*i.e.*, the call equivalent position) would increase if the Company failed to meet certain specified financial goals, the warrants were derivative securities only with respect to the number of shares originally underlying the warrants. However, with respect to the additional shares of stock to be issued if the Company did not meet its financial goals, they would be deemed acquired on the date they were issued.

Here, applying *Davis Polk* and *Jenny Craig* to this action confirm the interpretation reached by the plain language of Rule 16b-6(a) and a reasonable reading of the rule's regulatory history, and correctly results in the Preferred Stock being deemed a derivative security on the date it was acquired by Defendants. The increased number of shares into which the Preferred Stock became convertible constituted a Section 16(b) purchase only on the date those provisions became effective.

B. The Circuit Court's Views on the Statutory Purpose of Section 16(b) and the Impact on Liability Are in Error and Contrary to This Court's Decisions on the Same Issues

The Circuit Court also justified its decision as being "consistent with the statutory purpose." *Morrison*, 463 F.3d at 315 (App. 7). Specifically, the Circuit Court opined that "[t]he potential for abuse is minimal when the adjustments are automatic, and the triggering events were specified at the time when the stock was purchased." *Id.*

However, the Circuit Court cites no support either from the legislative record or from this Court's prior decisions discussing the statutory purpose of Section 16(b). *Id.* Petitioner respectfully submits that this finding concerning Section 16(b)'s statutory purpose is inconsistent with this Court's decisions addressing the issue.

Section 16(b)'s goal is to prevent manipulative trading and the resulting harm to the securities markets and other elements of the national economy. *See* 15 U.S.C. §78p(b); *see also*, 15 U.S.C. §78b (cited in *Gollust v. Mendell*, 501 U.S. 515, 121 (1991)). It is equally clear that Congress intended to accomplish this result by requiring insiders to disgorge any profits obtained from matching "***any*** purchase" with "***any*** sale" occurring within a six month period. *See* 15 U.S.C. §78p(b) (emphases added). *Accord*, *Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 253 (1976) ("Congress thought that ***all*** short-swing trading by directors and officers was vulnerable to abuse because of their intimate involvement in corporate affairs.") (emphasis added). "[T]he only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great." *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972).

This Court has allowed certain transactions to be exempted from Section 16(b) liability. However, such an exemption has been held to be appropriate only where "the involuntary nature of [the] exchange, [is] coupled with the absence of the possibility of speculative abuse of inside information." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 600 (1973). *See also*, A.S. Jacobs, *Section 16 of the Securities Exchange Act*, §3.12 at 3-110-11

(2003) ("under *Kern County* – ***both factors – involuntariness and no access to inside information – must exist before an unorthodox transaction can escape being a statutory purchase or sale.***") (emphasis added).

Here, Defendants are still presumed to have inside information based upon, *inter alia*, their having designated one of the members of XM's board of directors.[7] Thus, the mere fact that a transaction is automatic or involuntary is insufficient to take it outside the scope of those transactions which Section 16(b) was intended to address.

Also, the Circuit Court extended the holding of *Kern County* from a situation in which the involuntary transaction caused the imposition of Section 16(b) damages to one in which, as here, the statutory insider could have avoided all liability by simply refraining from selling for a period of six months. *Accord*, *Foremost*, 423 U.S. at 252 ("Even an insider may trade freely without incurring the statutory liability if, for example, he spaces his transactions at intervals greater than six months."). No one forced Defendants to sell XM stock and realize a short-swing profit. Having done so voluntarily, they ought not to be in the position of crying foul or claiming unfairness.

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[7] Defendants are presumed to have access to inside information by virtue of their insider position. *See, e.g., Mendell v. Gollust*, 909 F.2d 724, 728 (2d Cir. 1990) ("The statute presumes that insiders in a company have access to non-public information regarding its operation and will use that information when trading in the issuer's stock, and thus proof of the actual use of such inside information is not required.") (citing *Foremost-McKesson, supra*, 423 U.S. at 243 & 251; *Reliance Elec., supra*, 404 U.S. at 422)).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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LARRY MORRISON, Appellant v. MADISON DEARBORN CAPITAL PARTNERS III L.P.; MADISON DEARBORN SPECIAL EQUITY III L.P.; MADISON DEARBORN PARTNERS III L.P.; MADISON DEARBORN PARTNERS LLC; XM SATELLITE RADIO HOLDINGS INC.

No. 05-4901

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

463 F.3d 312; 2006 U.S. App. LEXIS 23739; Fed. Sec. L. Rep. (CCH) P93,956

September 14, 2006, Submitted Under Third Circuit Lar 34.1(a)
September 19, 2006, Filed

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JUDGES: Before SLOVITER, WEIS, and GARTH, Circuit Judges.

OPINION BY: SLOVITER

OPINION:

OPINION OF THE COURT

SLOVITER, Circuit Judge.

I.

Larry Morrison, a shareholder of XM Satellite Radio Holdings, Inc. ("XM"), brought a derivative suit under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), to recover alleged short-swing profits realized by corporate insiders Madison Dearborn Capital Partners III, L.P., Madison Dearborn Special Equity III, L.P., Madison Dearborn Partners III, L.P., and Madison Dearborn Partners, LLC (collectively "Madison Dearborn"). The District Court dismissed the complaint for failure to state a claim on which relief can be granted. Fed. R. Civ. P. 12(b)(6). Morrison appeals.

II.

In August 2000, Madison Dearborn purchased 50,000 shares of "8.25% Series C Convertible Redeemable Preferred Stock Due 2012" (hereinafter "Preferred Stock") issued by XM for $1000 per share. Combined with other purchases, Madison Dearborn was the beneficial owner of 13.58% of the underlying XM Common Stock.

Holders of Preferred Stock are entitled to exchange their shares for XM Common Stock. The Certificate of Designation for the Preferred Stock set the conversion price at $26.50 per share, but also contained "anti-dilution" provisions which automatically decreased the

conversion price when certain events occurred, such as a stock split, payment of dividends, or issuance of additional Common Stock. By 2003, the conversion price had decreased to $19.68. On and subsequent to January 28, 2003, XM issued additional Common Stock, which further reduced the conversion price to $8.96 per share as of June 30, 2003. Prior to the adjustment, Madison Dearborn was entitled to convert its Preferred Stock into 2,540,650 shares of Common Stock. Afterwards, it was entitled to 5,580,357 shares but never exercised its right to convert those shares.

In June 2003, Madison Dearborn sold 2,674,154 shares of XM Common Stock that it had acquired independently of the Preferred Stock. Morrison requested that XM bring suit against Madison Dearborn to recover the alleged short-swing profits realized by this sale. When XM declined to do so, Morrison brought this derivative shareholder lawsuit.

III.

The District Court had jurisdiction over this action under 15 U.S.C. § 78aa. We have jurisdiction over this appeal from the final judgment of the District Court under 28 U.S.C. § 1291. We exercise plenary review over the order dismissing the complaint, as well as the District Court's interpretation of securities law. *In re Rockefeller Ctr. Properties, Inc. Sec. Litig.*, 311 F.3d 198, 215 (3d Cir. 2002). When reviewing a motion to dismiss, "we accept all factual allegations in the complaint as true and view them in the light most favorable to the plaintiff[ ]." *Accardi v. IT Litig. Trust* (*In re IT Group, Inc.*), 448 F.3d 661, 667 (3d Cir. 2006).

IV.

Section 16(b) of the Securities Exchange Act of 1934 prohibits corporate insiders from using their privileged position to profit from short-term transactions in the company's stock. 15 U.S.C. § 78p(b).[1] Short-swing trading is a strict-liability offense and does not require proof of actual abuse of insider information or an intent to profit from such information. *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 251, 96 S. Ct. 508, 46 L. Ed. 2d 464 (1976). The plaintiff need only prove that "'there was (1) a purchase and (2) a sale of securities (3) by an officer or director of the issuer or by a shareholder who owns more than ten percent of any one class of the issuer's securities (4) within a six month period.'" *Levy v. Sterling Holding Co.*, 314 F.3d 106, 111 (3d Cir. 2002) (quoting *Gwozdzinsky ex rel. Revco D.S., Inc. v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998)). For the purposes of the motion to dismiss, Madison Dearborn does not dispute that it is a corporate insider or that it sold almost 2.7 million shares of XM Common Stock in June

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[1] Section 16(b) provides, in pertinent part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of the issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction. . . . **This subsection shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.**

15 U.S.C. § 78p(b) (2006) (emphasis added).

2003. The only issue is whether the automatic adjustment to the conversion price of the Preferred Stock in January 2003, was a "purchase" of securities.

The Securities Exchange Act of 1934 authorizes the SEC to enact regulations defining which transactions are included in the ban on short-swing trading and which are "exempt as not comprehended within the purpose of this subsection." 15 U.S.C. § 78p(b). In 1991, the SEC adopted new regulations on the applicability of Section 16(b) to transactions in derivative securities. A derivative security is "any option, warrant, *convertible security*, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security. . . . " 17 C.F.R. § 240.16a-1(c) (emphasis added).

The parties agree that, because the Preferred Stock is convertible into Common Stock, the Preferred Stock is a derivative security. More specifically, the Preferred Stock is a "call equivalent position," because it "increases in value as the value of the underlying equity increases. . . ." 17 C.F.R. § 240.16a-1(b). The regulations state that "[t]he establishment of or an increase in a call equivalent position . . . shall be deemed a purchase of the underlying security for purposes of section 16(b). . . ." 17 C.F.R. § 240.16b-6(a). Morrison argues that the adjustment in the conversion price increased Madison Dearborn's call equivalent position from 2,540,650 shares to 5,580,357 shares of XM Common Stock. Thus, he argues, under the plain meaning of the regulations, the adjustment constituted a "purchase."

Morrison's argument is contrary to the SEC's interpretation of the regulations. An agency's reasonable interpretation of its own regulations "attracts substantial judicial deference." *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220, 121 S. Ct. 1433, 149 L. Ed. 2d 401 (2001) (citation omitted). "Our task is not to decide which among several competing interpretations best serves the regulatory purpose. Rather, the agency's interpretation must be given controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512, 114 S. Ct. 2381, 129 L. Ed. 2d 405 (1994) (internal quotation marks omitted). Deference is especially warranted when the regulations concern "a complex and highly technical regulatory program [.]" *Id.* (internal quotation marks omitted). Particular weight is given to agency interpretations made at the time the regulations are promulgated. *Gardebring v. Jenkins*, 485 U.S. 415, 430, 108 S. Ct. 1306, 99 L. Ed. 2d 515 (1988).

The SEC anticipated, and rejected, Morrison's argument. In the release announcing the new regulations, the SEC states that the regulations only apply to derivatives with a "fixed exercise price." Ownership Reports and Trading By Officers, Directors and Principal Security Holders, 56 Fed. Reg. 7242, 7252 (Feb. 21, 1991) (hereinafter "Release"). The Release clarifies what constitutes a "fixed" price, saying,

> A convertible security with a fixed conversion privilege is deemed to have a fixed exercise price. A derivative security having a series of preset prices, or having a price that is adjusted to reflect pre-specified events such as a stock split, is

> considered fixed for purposes of the Rule. *The adjustments for pre-specified events do not constitute acquisitions of additional equity securities.*

Release, at 7252 n.134 (emphasis added). Therefore, under the SEC's interpretation, the adjustment to the conversion price of the Preferred Stock is not a "purchase."

The SEC's interpretation is consistent with the statutory purpose. The ban on short-swing trading was enacted "[f]or the purpose of preventing the unfair use of information which may have been obtained by [corporate insiders.]" 15 U.S.C. § 78p(b). The SEC has attempted to identify those transactions which have a "potential for abuse." Release, at 7249. The potential for abuse is minimal when the adjustments are automatic, and the triggering events were specified at the time when the stock was purchased. The shareholder cannot control when, or even if, the adjustment occurs. *Cf. Lerner v. Millenco, L.P.*, 23 F. Supp. 2d 337, 343 (S.D.N.Y. 1998) (holding that a shareholder *had* purchased additional securities by negotiating with the company to reduce the conversion price of convertible debentures). While the possibility of insider trading is not entirely eliminated, it is not so great as to impose strict liability as provided in Section 16(b).

V.

We defer to the SEC's reasonable position that an automatic adjustment to the conversion price of a derivative security is not a "purchase" for the purposes of Section 16(b). The District Court fully considered Morrison's arguments before rejecting his arguments that the increase in the conversion ratio subjected Madison Dearborn

to liability under Section 16(b). Therefore, we will affirm the decision of the District Court to dismiss the complaint.

LARRY MORRISON, Plaintiff, v. MADISON DEARBORN CAPITAL PARTNERS III, L.P., MADISON DEARBORN SPECIAL EQUITY III, L.P., MADISON DEARBORN PARTNERS III, L.P., MADISON DEARBORN PARTNERS, LLC and XM SATELLITE RADIO HOLDINGS INC., Defendants.

Civil Action No. 04-010-KAJ

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

389 F. Supp. 2d 596; 2005 U.S. Dist. LEXIS 22603; Fed. Sec. L. Rep. (CCH) P93,535

October 5, 2005, Decided

COUNSEL: Jeffrey S. Goddess, Rosenthal, Monhait, Gross & Goddess, P.A., Wilmington, Delaware, for Plaintiff. Of Counsel: Jack G. Fruchter, Abraham, Fruchter & Twersky, LLP, New York, New York.

Lisa A. Schmidt, Michael R. Robinson, Richards, Layton & Finger P.A., Wilmington, Delaware; Lawrence C. Ashby, Carolyn S. Hake, Ashby & Geddes, Wilmington, Delaware, for Defendants. Of Counsel: J. Andrew Langan, Kathryn F. Taylor, Kirkland & Ellis LLP, Chicago, Illinois; John C. Keeney, Jr., Hogan & Hartson LLP, Washington, D.C.; James I. Rim, Hogan & Hartson LLP, New York, New York.

JUDGES: JORDAN, District Judge.

OPINION BY: Kent A. Jordan

OPINION:

MEMORANDUM OPINION

October 5, 2005
Wilmington, Delaware

JORDAN, District Judge

I. INTRODUCTION

Plaintiff, a shareholder of XM Satellite Radio Holdings Inc. ("XM Radio"), brought this derivative action to recover profits from short-swing insider trading of XM Radio stock by Madison Dearborn Capital Partners III, L.P., Madison Dearborn Special Equity III, L.P., Madison Dearborn Partners III, L.P., and Madison Dearborn Partners, LLC (collectively, "MDP"). Before me are Motions to Dismiss under Fed. R. Civ. P. 12(b)(6) filed by MDP (Docket Item ["D.I."] 14) and XM Radio (a nominal defendant) (D.I.11). The court has jurisdiction over the subject matter of this action under 28 U.S.C. § 1331 and 15 U.S.C. § 78aa; jurisdiction over the parties and venue for this action are uncontested. For the reasons that follow, the Motions to Dismiss will be granted.

II. BACKGROUND[1]

On August 8, 2000, MDP acquired 50,000 shares of "8.25% Series C Convertible Redeemable Preferred Stock Due 2012" ("Preferred Stock") issued by XM Radio at a price of $1,000 per share. This purchase, along with previous acquisitions, gave MDP beneficial ownership of

[1] The following background information is based on plaintiff's allegations, which are assumed to be true for the purposes of these 12(b)(6) motions.

13.58% of the underlying XM Radio common stock. Holders of the Preferred Stock could exchange these shares for XM Radio common stock at a price initially set to $26.50 per share of common stock. The Certificate of Designation for the Preferred Stock ("Certificate") (D.I.15, Ex. B)[2] required that this conversion price be adjusted to maintain the value of the conversion privilege if one of a series of prespecified events occurred that would dilute this value. For example, stock splits, payment of stock dividends to common stock holders, or issuance of additional common stock would dilute the common stock that could be acquired by Preferred Stock holders, and so if any of these events happened, XM Radio was required to adjust the conversion price. This price adjustment would be made automatically according to a set formula that corrected for dilution by the triggering event. For example, if additional stock were issued:

> the new Conversion Price shall be determined by multiplying the Conversion Price then in effect by a fraction, (x) the numerator of which shall be the number of shares of Common Stock outstanding immediately prior to such issuance (the "Outstanding Common") plus the number of shares of Common Stock that the aggregate consideration received by the Issuer for such issuance would purchase at such Conversion Price;

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[2] The Certificate of Designation is a publicly-available document filed with the Delaware Secretary of State. A certified copy of the document was included with MDP's brief in support of this motion, and it may be considered along with plaintiff's allegations. *See S. Cross Overseas Agencies, Inc. v. Wah Kwong Shipping Group, Ltd.*, 181 F.3d 410, 426 (3d Cir. 1999) ("To resolve a 12(b)(6) motion a court may properly look at public records . . . in addition to the allegations in the complaint.").

> and (y) the denominator of which shall be the number of shares of Outstanding Common plus the number of shares of such Additional Stock.

(*Id.* at § 4.2(d)(i)).

Due to events prior to January 2003, the conversion price for Preferred Stock was adjusted from the initial value of $26.50 to $19.68. At this adjusted conversion price, MDP's 50,000 shares of Preferred Stock could be exchanged for approximately 2.5 million shares of common stock. XM Radio issued additional common stock in January 2003, and the conversion price was accordingly adjusted again to $8.96. At this adjusted price, MDP could exchange its Preferred Stock for approximately 5.6 million shares of common stock. Plaintiff has not alleged that MDP exercised its conversion privilege.

In June 2003, within six months of the January conversion price adjustment, MDP sold 2.7 million shares of XM Radio common stock that it had acquired independently of its Preferred Stock. According to plaintiff, MDP still beneficially owned more than 10% of the XM Radio common stock after this sale.

Plaintiff argues that the January conversion price adjustment was a "purchase" of XM Radio common stock that occurred within six months of the June 2003 sale, and so, under Section 16(b) of the Securities Exchange Act of 1934 ("Section 16(b)"), MDP must turn over its profits from this short-swing trading. 15 U.S.C. § 78p(b) (2004). Plaintiff made a written demand on October 16, 2003 for XM Radio to bring this action to recover MDP's profits, and when XM Radio declined, plaintiff brought this derivative action.

III. STANDARD OF REVIEW

Fed. R. Civ. P. 12(b)(6) requires a court to accept as true all material allegations of the complaint. *See Trump Hotels & Casino Resorts, Inc. v. Mirage Resorts, Inc.*, 140 F.3d 478, 483 (3d Cir. 1998) (internal citation omitted). "A complaint should be dismissed only if, after accepting as true all of the facts alleged in the complaint, and drawing all reasonable inferences in the plaintiff's favor, no relief could be granted under any set of facts consistent with the allegations of the complaint." *Id.* (internal citation omitted). The moving party has the burden of persuasion. *See Kehr Packages, Inc. v. Fidelcor, Inc.*, 926 F.2d 1406, 1409 (3d Cir. 1991).

IV. DISCUSSION

A. The Purpose and Strictures of Section 16(b)

Section 16(b) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of the issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction . . . .

15 U.S.C. § 78p(b) (2004).

Because of the danger of corporate insiders using inside information to generate profits from short-term buying and selling of their company's stock, Congress

imposed strict liability for profiting from purchases and sales made within six months of each other. *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 320 (2d Cir. 1998). Thus, "no showing of actual misuse of inside information or of unlawful intent is necessary to compel disgorgement." *Id.; see also Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 251, 46 L. Ed. 2d 464, 96 S. Ct. 508 (1976). Rather, the statute operates mechanically to force insiders to turn over any short-swing profits. To state a claim under Section 16(b), plaintiff must allege that "there was (1) a purchase and (2) a sale of securities (3) by an officer or director of the issuer or by a shareholder who owns more than ten percent of any one class of the issuers securities (4) within a six-month period." *Levy v. Sterling Holding Co.*, 314 F.3d 106, 111 (3d Cir. 2002); *see also Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998). For purposes of these motions, MDP[3] does not dispute its insider status, or that it sold XM Radio stock in June 2003. The only issue before me is whether plaintiff has alleged a "purchase" that occurred within six months of the June 2003 sale.

Plaintiff argues that the January 2003 conversion price reduction for the Preferred Stock is a "purchase" under Section 16(b), as interpreted under Securities and Exchange Commission ("SEC") Rule 16b-6(a). Because of the conversion privilege, the parties agree that the Preferred Stock is a derivative security according to Rule 16a-1(c). 17 C.F.R. § 240.16a-1(c) (2004). As the value of XM

[3] XM Radio has waived its right to file separate briefs in support of its motion to dismiss, and has joined in MDP's briefs. Therefore, my analysis of MDP's arguments determines the disposition of XM Radio's motion as well.

Radio common stock increases, the value of the Preferred Stock with its conversion privilege increases. Thus, the conversion privilege operates like a call option covering the underlying XM Radio stock, and so, under Rule 16a-1(b), the Preferred Stock is a "call equivalent position." 17 C.F.R. § 240.16a-1(b) (2004). As a call equivalent position, the Preferred Stock is subject to Rule 16b-6(a), which provides that "the establishment of or increase in a call equivalent position . . . shall be deemed a purchase of the underlying security for purposes of section 16(b)." 17 C.F.R. § 240.16b-6(a) (2004).

The January 2003 conversion price reduction gave MDP the privilege of obtaining over 3 million additional shares in exchange for its Preferred Stock. According to plaintiff, this is an "increase in a call equivalent position" that should be treated as a purchase of XM Radio stock for determining Section 16(b) liability. Because this interpretation of Rule 16b-6(a) differs from that of the SEC, and because it is not consistent with the purpose behind Section 16(b) and Rule 16b-6, I disagree with plaintiff's position and conclude that the January 2003 conversion price reduction is not a purchase.

B. SEC Revision of Rules Under Section 16(b)

In 1991, the SEC revised its Rules under Section 16(b) "in response to developments in the trading of derivative securities." Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, 56 Fed. Reg. 7242, 7243 (Feb. 21, 1991) ("1991 SEC Release"). The revisions made it clear that for derivative securities, the relevant event for Section 16(b) purposes is the purchase or sale of the

derivative security rather than its exercise or conversion. *Id.* at 7252-53. For example, the purchaser of a convertible security is able to lock in a conversion price for the underlying stock when the convertible security is purchased, making that a time when an insider could take advantage of inside information to set up or realize a short-swing profit. Therefore, Rule 16b-6(a) requires that "the establishment of or increase in a call equivalent position . . . shall be deemed a purchase of the underlying security for purposes of section 16(b)." 17 C.F.R. § 240.16b-6(a). The later conversion into the underlying stock is a change of form but not of substance. Thus, the conversion is a non-event under Section 16(b). *See Magma Power*, 136 F.3d at 321-22; 1991 SEC Release, at 7253.

The situation changes if the conversion price is not fixed at the time the convertible security is purchased. For example, if the conversion price is set at a percentage of the market price, the conversion price will float, and the time for an insider to take advantage of non-public information would be at the conversion of the stock, rather than the time of purchase. *See Lerner v. Millenco, L.P.*, 23 F. Supp. 2d 337, 341-42 (S.D.N.Y. 1998); 1991 SEC Release, at 7253. Because the danger of insider trading occurs at a different time for securities with floating conversion prices, Rule 16a-1(c)(6) excludes them from the derivative securities subject to Rule 16b-6, and the relevant event under Section 16(b) is the conversion. *See Lerner*, 23 F. Supp. 2d at 342.

C. The Rules Applied, In Light of the SEC's Interpretation

Here, the conversion price for the Preferred Stock was adjusted because of the issuance of additional XM Radio

stock. Plaintiff argues that the adjustment is an increase in a call equivalent position, and therefore a purchase under Rule 16b-6(a), because it allows MDP to acquire additional XM Radio stock. But it appears that the SEC anticipated such price adjustments and reached a different conclusion. In the 1991 Release, as the revised Rule 16b-6 was promulgated, the SEC stated that:

> A convertible security with a fixed conversion privilege is deemed to have a fixed exercise price. A derivative security having a series of preset prices, or having a price that is adjusted to reflect pre-specified events such as a stock split, is considered fixed for purposes of [Rule 16a-1(c)]. The adjustment for pre-specified events do not constitute acquisitions of additional equity securities.

1991 SEC Release, at 7252 n.134. Stock splits, payment of stock dividends, and issuance of additional stock were prespecified in the Certificate as events requiring the adjustment of the conversion price for the Preferred Stock. The SEC release thus demonstrates that, when the Rules were revised to better account for derivative securities trading, the SEC intended the following: (1) that securities like the Preferred Stock would be treated as if they had a fixed conversion price; (2) that, as a result, such securities would be derivative securities under Rule 16a-1(c); (3) that adjusting the conversion price would not be an acquisition of additional stock; and (4) that under Rule 16b-6, the relevant event would be the purchase of the Preferred Stock, not the change in conversion price.

Congress gave the SEC the power to exclude transactions from the reach of Section 16(b). 15 U.S.C. § 78p(b) ("This subsection shall not be construed to cover . . . any

transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."). Thus, courts often defer to the SEC's interpretations, even when they are not formalized as Rules. *See, e.g., Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2d Cir. 2000) (deferring to SEC interpretations presented in an amicus brief); *Schaffer ex rel. Lasersight Inc. v. CC Invs., LDC*, 280 F. Supp. 2d 128, 143 (S.D.N.Y. 2003) (same).

Here, the statement in the 1991 Release is not only clear, it is consistent with the policy behind the treatment of derivative securities under Rule 16b-6. The purchase of derivative securities is the relevant event under Rule 16b-6 because, at that point, the buyer is able, for the last time, to negotiate the price at which the underlying stock will be obtained. Thus, that is the last time that inside information can be exploited when setting the purchase price. In contrast, a security with a floating price leaves the purchaser the option of setting a price later, as the market fluctuates. MDP's last opportunity to influence the conversion price of the Preferred Stock was when it actually purchased the stock in August 2000. The later, automatic adjustments to the price only maintained the value of MDP's conversion privilege in the face of dilution from the issuance of additional stock, and the formula for those adjustments was set at the time the Preferred Stock was issued. Thus, as the SEC stated in the 1991 Release, for the purposes of Section 16(b), the conversion price for the

Preferred Stock should be treated as fixed, and changes in the price should not be treated as purchases.[4]

This result is not inconsistent with the lone case that plaintiff points out as an example of conversion price adjustments being considered purchases under Section 16(b). In *Lerner v. Millenco, L.P., supra*, the court concluded that a reduction in the conversion price for a convertible debenture "raised the number of shares that [the holder] could acquire by converting the debentures, and thus increased the defendant's call equivalent position." 23 F. Supp. 2d at 343. So, under Rule 16b-6(a), the reduction was a purchase of the underlying stock. *Id.* But the conversion price reduction in *Lerner* resulted from a separate agreement between the holder and issuer to modify a price that was fixed when the debentures issued. *Id.* at 339. In return for this favorable revision of the "conversion formula," the debenture holder agreed not to exercise the conversion privilege for several months. *Id.* This adjustment was not made in response to prespecified events. The automatic conversion price adjustment for the XM Radio Preferred Stock was set when the stock was issued, making it qualitatively different from the negotiated one-time adjustment in *Lerner.*

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[4] MDP also argues that several SEC no-action letters support the view that the conversion price adjustment was not a purchase under Section 16(b). (D.I. 15 at 15) (citing Diasonics Inc., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 76,695 (Sept. 27, 1993); Control Data Corp., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 76,231 (July 30, 1992); Pittston Co., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 76,164 (May 18, 1992); Cravath, Swaine & Moore, SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 76,002 (Oct. 22, 1991)). These no-action letters make fact-specific determinations about the effect of anti-dilution adjustments to employee incentive plans, and so are of limited utility in examining the circumstances here.

Plaintiff also points to cases involving hybrid derivative securities, and argues that the Preferred Stock should be treated similarly. A hybrid derivative security gives the holder an option to purchase at either a fixed price or a floating price. *See Schaffer*, 280 F. Supp. 2d at 130; *Levy v. Clearwater Fund IV, Ltd.*, No. CIV.A.99-004, 2000 WL 152128, at *1 (D. Del. Feb. 2, 2000). At the time a hybrid derivative security is purchased, the buyer has locked in a maximum price and a minimum number of shares that can be purchased with the fixed price option. As the market price changes, the floating price option leaves open the possibility that the buyer will be able to choose a lower price (and obtain a greater number of shares). *See id.* In at least one case, such securities have been treated as two separate pieces: the minimum number of shares obtainable at the fixed price are viewed as being purchased when the derivative security is purchased, and any additional shares obtained by choosing the floating price are deemed to be purchased when the derivative security is converted. *Schaffer*, 280 F. Supp. 2d at 140.

Plaintiff argues here that the Preferred Stock should be treated similarly to hybrid derivative securities, so that the purchase of Preferred Stock is considered a purchase of the underlying stock that can be obtained at the then-current price, and additional shares that can be obtained after conversion price reductions are treated as being purchased when the price adjustment is made. But, as already noted, holders of the Preferred Stock, unlike those who hold hybrid derivative securities, have no choice: the price is determined automatically by factors that do not include the market price. Thus, the Preferred Stock should be treated as if it had a fixed conversion price. In any event, treating the Preferred Stock like a hybrid derivative

security would mean that the relevant events for Section 16(b) would be the purchase of the Preferred Stock, which took place outside the six-month window, and its conversion, which has not been alleged to have taken place at all. Thus, plaintiff's argument still fails.[5]

The SEC has stated that securities like the Preferred Stock, with conversion prices adjusted for prespecified events, should be treated as if they had a fixed price, and that a conversion price adjustment should not be treated as a purchase. This treatment is consistent with Congress's purpose of preventing short-swing insider trading. I therefore conclude that the January 2003 conversion price reduction is not a purchase, and as a result, plaintiff has failed to state a claim under Section 16(b).[6]

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[5] Plaintiff also argues that two SEC no-action letters support his claim that the Preferred Stock should be treated as a two-part hybrid security. (D.I. 24 at 16-17) (citing Jenny Craig, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 76,068 (Jan. 30, 1992); Davis, Polk & Wardwell, SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 79,769 (Aug. 23, 1991)). These no-action letters address situations where additional shares are granted as dividends or compensation for poor company performance rather than as prespecified anti-dilution measures, and so they are not persuasive here.

[6] MDP argued in its initial brief that the Preferred Stock conversion privileges were exempt from Section 16(b) under SEC Rule 16a-9(b). (D.I. 15 at 11-12.) Plaintiff countered with factual contentions concerning the application of this rule, and since these motions are granted on other grounds, I need not decide that issue here.

MDP also argued that the conversion price reduction is an "unorthodox transaction" that does not present the danger of speculative abuse. (*Id.* at 19-24.) *See Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593-95, 36 L. Ed. 2d 503, 93 S. Ct. 1736 (1973). Because the SEC stated how its Rules should apply in this case, deciding the "unorthodox transaction" issue is unnecessary. I note, however, that the factual nature of the inquiry likely makes it "inappropriate for resolution on a motion to dismiss." *Clearwater*, 2000 U.S. Dist. LEXIS 1305, 2000 WL 152128, at *7.

V. CONCLUSION

Accordingly, I will grant XM Radio's and MDP's Motions to Dismiss under Fed. R. Civ. P. 12(b)(6). An appropriate order will issue.

ORDER

For the reasons set forth in the Memorandum Opinion issued in this matter today,

IT IS HEREBY ORDERED that the Motions to Dismiss (D.I. 11; D.I. 14) are GRANTED.